

89-SBE-018

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
DENTAL INSURANCE CONSULTANTS,) No. 86R-1798-CD
INC.)

Appearances:

For Appellant: Harry T. Kaplan
Attorney at Law

For Respondent: Lorrie K. Inagaki
Counsel

O P I ' N I O N .

This appeal was originally made pursuant to section 18593¹/ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Dental Insurance Consultants, Inc., against a proposed assessment of additional franchise tax in the amounts of \$16,264, \$15,552, and \$23,211 for the years 1980, 1981 and 1982, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

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The question presented by this appeal is whether appellant Dental Insurance Consultants, Inc. (DIC) and its wholly owned subsidiary D.I.C. Farms, Inc. (Farms) were engaged in a unitary business during the 1980, 1981, and 1982 income years .

DIC is a California corporation which provides review and advice regarding dental insurance claims for various insurance companies. Its headquarters is located in Saratoga, California, and it has additional offices in California, several other states, and Canada. Each office has two dentists who coordinate the efforts of dentists who have been engaged, as subcontractors, to assist in reviewing and making recommendations regarding these claim,. During the appeal years, DIC enjoyed significant profits.

The president and majority shareholder of DIC was Richard Guenther. Its vice-president was Ernest Giachetti, and its secretary and treasurer was Harry Kaplan. These men made up DIC's board of directors, and Kaplan also served as DIC's attorney. Farms is incorporated in Nevada, but operates a number of small farms exclusively in California. The Farms ' primary crops are oranges, plums, grapes, and jojoba beans.

Farms was formed by DIC to provide diversification from DIC's dental insurance consulting business. Among DIC's primary motives for diversifying from its main line of business was a concern about increasing competition. The management of DIC also thought that Farms' properties would provide DIC with a hedge against inflation. In terms of Farms' economic viability, DIC concluded that Farms could compete effectively in the farming business because DIC could provide Farms with an unusually consistent cash flow, as a result of DIC's profitability, and the financial expertise of DIC's management.

Guenther and Kaplan, officers and directors of DIC, were the majority directors of Farms and also served as officers of Farms. Kaplan was Farm's attorney, as well as the attorney for DIC. Barney R. Nielson, the pr-esident and remaining director of Farms, was its only employee. The exact limits of Nielson's responsibilities are in dispute, but they consisted, at a minimum, of investigating business opportunities and presenting them to Farms' board of directors for approval. Ultimate policy decisions, particularly regarding investments and other financial matters, were the responsibility of Farms' board of directors, which, we infer, was dominated by Guenter. The daily operations of Farms were conducted by management firms that were unrelated c o DIC.

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Farms' **basic** support functions, such as accounting, bookkeeping, purchasing insurance, and check-writing **services**, were provided by DIC. DIC made capital contributions to **Farms**, lent Farms money, and provided guarantees for a number of Farms' obligations. In addition, other creditors apparently relied upon Farms' relationship with DIC when assessing Farms' financial strength. During the appeal years, Farms reported significant losses, which represented, in large part, deductions attributable to depreciation.

For these years, DIC filed its franchise tax returns on the basis of combined reports which included Farms. The Franchise Tax Board (FTB) determined that Farms was not **part** of **DIC's** unitary business during the 1980, 1981, and 1982 income years and issued proposed assessments based upon a recomputation of franchise tax liability that used the separate accounting method.

If a taxpayer derives income from sources both within and without California, its franchise tax liability is required to be measured by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code, §25101.) If the taxpayer is engaged in a single unitary business with affiliated corporations, its income attributable to California must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).)

There are two alternative tests that have customarily been used in California to determine whether a business is unitary. The California Supreme Court has held that the existence of a unitary business may be established by the presence of unity of ownership; unity of operation as evidenced by central accounting, purchasing, advertising, and management divisions; and unity of use in a centralized executive force and general system of operation. (Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), aff'd, 315 U.S. 501 [86 L.Ed. 991] (1942).) It has also stated that a business is unitary if the operation of the business done within California is dependent upon or contributes to the operation of the business outside California. (Edison California Stores, Inc. v. McColgan, *supra*, 30 Cal.2d at 481.) More recently, the United States Supreme Court has emphasized that affiliated corporations, to be considered a unitary group, must form a functionally integrated enterprise (Container Corp. v. Franchise Tax Board, 463 U.S. 159, 179 [77 L.Ed.2d 545], reh. den., 464 U.S. 909 [78 L.Ed.2d 2481] (1983)) in which factors of profitability arise from the operation of the business as a whole (F. W. Woolworth Co. v. Taxation & Rev. Dept., 458 U.S. 354, 364 [73 L.Ed.2d 819] (1982)).

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Respondent's determination regarding the existence of a unitary business is presumptively correct, and appellant bears the burden of showing that it is incorrect. (Appeal of Kikkoman International, Inc., Cal. St. Bd. of Equal., June 29, 1982.)

Appellant contends that its unity with Farms is established, under either test, by the existence of the following factors: unity of ownership, financial interdependence, common management, and common support services. Respondent maintains that, although unity of ownership existed, DIC and Farms **were** engaged in diverse types of activities which were insufficiently integrated to be considered a single unitary business under either the three unities test or the contribution or dependency test. We **agree** with respondent.

To demonstrate the existence of a single unitary business, it is necessary to do more than simply list circumstances which are labeled "unitary factors." Such "factors" are distinguishing features only when they show that there was functional integration between the corporations or divisions involved. (Appeals of Santa Anita Consolidated, Inc., et al., Cal. St. Bd. of Equal., Apr. 5, 1984.) We must distinguish

between those cases in which unitary labels are applied to transactions and circumstances which, upon examination, have **no** real substance, and those in which the factors involved show such a significant interrelationship among the related entities that they all must be considered to be parts of a single integrated economic enterprise.

(Appeal of Saga Corporation, Cal. St. Bd. of Equal., June 25, 1982.)

To prevail, therefore, appellant must present sufficient evidence to show that the factors on which it relies resulted in the functional integration of activities of DIC and Farms rather than mere investment by a parent corporation in a subsidiary whose operations are unrelated to those of the parent. (Appeal of J. B. Torrance, Inc., Cal. St. Bd. of Equal., Wy 8, 1985; Appeals of Santa Anita Consolidated, Inc., et al., supra.)

In attempting to satisfy its burden, appellant places great emphasis on the capital contributions, loans, and guarantees of Farms' debt that it provided Farms. This

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intercompany financing, however, did not contribute in any way to common business activities of DIC and Farms, but rather served only **to provide** Farms with funds for its independent operations. Such financing merely enhanced Farms' value as an asset of DIC and thus was not a **distinguishing** unitary factor. (See Appeal of the Amwalt Group, Inc., -Cal. St. Bd. of Equal., July 28, 1983; Appeal of Simco, Incorporated, Cal. St. Bd. of Equal., Oct. 27, 1964.)

Similarly, the substantial interlocking among the officers and directors of the corporations, the control of Farms' major policies by DIC's officers/directors, and the financial guidance that this management provided Farms are frequently found when commonly controlled corporations operate a number of enterprises and are, in themselves, insufficient to show unity. (See Appeal of J. B. Torrance, supra; Appeal of Jaresa Farms, Inc., Cal. St. Bd. of Equal., Dec. 15, 1966.) As described by appellant, these factors were intended merely to make Farms a more productive asset for DIC and did not result in any integration between the corporations. (See Appeal of Santa Anita Consolidated, Inc., et al., supra; Appeal of Mole-Richardson Company, Cal. St. Bd. of Equal., Oct. 26, 1983.) In particular, the hiring of a farm management firm to conduct Farms' daily operations demonstrates that the DIC/Farms management lacked the expertise, other than in providing financial guidance, that is associated with the integrated management of a unitary business. (See Appeal of Hollywood Film Enterprises, Inc., Mar. 31, 1982.) The common support functions stated by appellant have not been shown to have resulted in any material advantage and, therefore, are not significant.

Despite appellant's extensive list of purportedly unitary factors, it has not shown how these factors caused its business activities to be integrated with those of Farms. in rejecting appellant's position, we conclude that Farms served for DIC 'the primary function of diversifying the corporate portfolio and reducing the risks inherent in being tied to one industry's business cycle,' rather than 'to make better use--either through economics of scale or through operational integration or sharing of expertise--of the parent's existing business resources.'" (Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 178.)

Because unity between DIC and Farms has not been **established**, the action of the FTB will be sustained.

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O R D E R

Pursuant to **the** views expressed in the opinion of the board on file in **this** proceeding, and **good** cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim **of** Dental Insurance Consultants, Inc. for refund of personal income tax in the amounts of \$16,264, \$15,552, and \$23,211 for the years 1980, 1981, and 1982, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of August, **1989**, by the State Board of Equalization, with Board Members Mr. Carpenter, Mr. Collis, Mr. Bennett, Mr. Dronenburg, and Mr. Davies present.

<u>Paul Carpenter</u>	, Chairman
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>John Davies*</u>	, Member

*For Gray Davis, per Government Code section 7.9